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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
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In the Matter of	)	
	)	
Implementation of the Pay Telephone Reclassification And Compensation Provisions of the Telecommunications Act of 1996	)	CC Docket No. 96-128

REPLY COMMENTS OF AT&T CORP.

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SUMMARY

The comments submitted to the Commission exhibit overwhelming agreement by disparate parties – including interexchange carriers, paging companies, vertically integrated firms like Sprint, consumer groups, and state PUCs – that the compensation rate for dial-around and subscriber 800 calls set out in the Second Report and Order is far too high. From those comments, two related and inescapable conclusions emerge. First, the compensation scheme proposed in the Second Report and Order is irrational because it is based on the deregulated local coin rate. The comments here leave no room for doubt that the payphone industry is largely immune to price competition. Thus, there is no basis to assume that the local coin rate is a rational starting point to calculate a compensation rate for coinless calls. Second, given the absence of price constraining competitive forces, the 28.4 cents compensation rate is predictably much higher than the costs of an efficient PSP. Notably, the New York Public Service Department ("NYPSD") demonstrated in its comments that this rate is too high because Bell Atlantic had developed a cost study that shows that its costs for local coin calls are significantly less than 25 cents per call. NYPSD at 1. Coinless calls obviously generate even lower costs. This disparity has profound consequences for consumers, because every extra penny in the payphone compensation rate for dial-around and subscriber 800 calls costs customers $30 million each year.

Predictably, the only parties supporting the Second Report and Order's irretrievably flawed "market-based" approach are the PSPs. Their attempts, however, to shore up this inflated compensation arrangement fail at every turn. As an initial matter, they make no attempt to demonstrate that local coin rates converge to cost. Indeed, the LEC PSPs, who control the majority of payphones, steadfastly have refused to provide the information that would permit the

Commission to reach that conclusion. Instead, they have hidden behind the cost data supplied by the IPPs, who have much higher costs than the LECs. The LEC Coalition's decision to withhold this crucial information speaks for itself.

Just as important, the PSPs fail to acknowledge that the payphone business is not now, and has no prospect of becoming, competitive at the point of sale. While it might be true that payphone owners must compete with each other to install their phone equipment at some locations, once the payphones have been installed they do not compete with one another for the end user's business. If location owners sometimes have market power, as the LEC Coalition (at 23) claims, that market power is transferred to the payphone owners, further precluding any effective price competition and allowing the PSPs to charge even higher coin rates. Only by disassociating the compensation for dial-around and subscriber 800 calls from the deregulated local coin rate can the Commission ensure a just, reasonable, and nondiscriminatory coinless compensation rate. It is for precisely these reasons that the LEC experts' testimony attempting to justify the avoided cost method is fundamentally flawed. As CompTel (at 1) stated, the Commission "should now abandon its futile attempt to use the local coin rate in its search for a 'market-based' compensation amount."[1] Further, "[a]ny attempt by the Commission simply to shore up its previous approach . . . may convince the Court that . . . the Commission is too committed to its previous result to genuinely reconsider these issues again." Sprint at 14.

[1] See also Cable & Wireless at 1 ("the Commission can respond to the Court's concerns only by abandoning its misguided attempt to use the local coin rate as a 'market-based' surrogate for access code and subscriber 800 compensation.").

Obviously, then, another approach is required. The comments present the Commission with only three viable options. First, as the vast majority of commenters agree, the Commission could create a true market-based system by adopting a calling party pays compensation scheme for all calls, including dial-around and subscriber 800 calls. When a calling party must pay the cost associated with dial-around and subscriber 800 calls, the calling party internalizes that cost and has an incentive to choose the most affordable option, and in all events the caller assumes the costs of his decision to use a payphone. Second, AT&T and other commenters have shown that the Commission could develop a market surrogate based on negotiations among AT&T and IPPs regarding dial-around calls. Those negotiations reflect an arms-length bargaining process for the compensable calls between the actual parties involved in the compensation decision and therefore better emulate a competitive outcome. Third, the Commission could establish a fair compensation rate for dial-around and subscriber 800 calls based on the efficient costs of LEC PSPs, who operate the vast majority of payphones. This approach would better ensure that rates approximate costs as the D.C. Circuit has indicated they must. In all events, the Commission's compensation scheme should avoid the administrative nightmares that would inevitably result from a "floating" compensation rate.

Finally, even if the Commission persists in its efforts to base the compensation rate for dial-around and subscriber 800 calls on the deregulated local coin call rate, it must adopt the revisions described by AT&T in its December 1, 1997 Petition for Reconsideration. As AT&T demonstrated, the Second Report and Order's avoided cost approach contained several critical flaws that further inflate the compensation rate for dial-around and subscriber 800 calls above just and reasonable levels. They include: (i) relying on IPP cost data to the exclusion of data representative of the costs of efficiently provided payphone services; (ii) failing to deduct the profit on avoided costs; (iii) deducting an amount less than the full cost of local call completion; and (iv) adding costs for Flex-ANI. If these adjustments are not made, competition and consumers will be sure losers.

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REPLY COMMENTS OF AT&T CORP.

Pursuant to the Commission's Public Notice,[2] AT&T Corp. ("AT&T") hereby submits its Reply Comments on the issues remanded to the Commission by the Circuit Court of Appeals for the District of Columbia.

INTRODUCTION

The Commission's Notice (at 2) sought comments on several issues, most importantly whether or not the payphone business is competitive in a way that causes the deregulated local coin rate to converge toward cost. Rather than comply with the Commission's request and provide cost data that could resolve this issue, the LEC Coalition has continued to hide behind the IPPs' data and the fact that the Commission has deregulated the local coin market. As AT&T and other parties demonstrated in their comments[3], however, payphone service providers ("PSPs") only compete with one another to acquire the right to serve specific locations. They do

[2] Public Notice, Pleading Cycle Establish for Comment on Remand Issues in the Payphone Proceeding, DA 98-1198 (rel. June 19, 1998) ("Notice").

[3] A list of commenters and the abbreviations used to refer to each is appended as Attachment 1.

not compete for end users on the basis of price. As a result, market forces do not -- and cannot -- restrict the local coin rate paid by end users to an efficient level. In addition, the comments shows that the LEC PSPs have much lower costs than the IPPs. It is not surprising, then, that the record evidence convincingly answers the Commission's question in the negative – local coin rates have not and will not converge to the costs of an efficient PSP.

Consequently, the Commission has only three options. First, the Commission could create a true market-based system by adopting a calling party pays compensation scheme for all payphone calls, including dial-around and subscriber 800 calls. Under this alternative compensation arrangement, the calling party internalizes that cost and has at least some incentive to make a market-based decision. Second, the Commission could retain the carrier pays mechanism and develop a market surrogate based on negotiations among AT&T and IPPs regarding dial-around calls. Those negotiations reflect an arms-length bargaining process and therefore better emulate a competitive outcome than the scheme laid out in the Second Report and Order. Third, the Commission could establish a fair compensation rate for carriers to pay PSPs for dial-around and subscriber 800 calls based on a bottom-up view of the efficient costs of LEC PSPs. Any other result would lead to an arbitrary and unsustainable result.

I. THE COMMENTS EVINCE WIDESPREAD SUPPORT FOR ALTERNATIVE MARKET BASED COMPENSATION SYSTEMS LIKE THOSE PROPOSED BY AT&T.

The comments demonstrate again the necessity of divorcing the compensation rate for dial-around and subscriber 800 calls from the deregulated local coin rate. With the exception of the PSPs who benefit from the supracompetitive 28.4 cent rate derived in the Second Report and

Order, all of the commenters have reached the same conclusion.[4] As AT&T explained in its Comments (at 12), if the Commission intends to use a market-based approach, it must choose one of the only two feasible compensation arrangements: requiring the calling party to pay or adopting a market-based surrogate based upon prior negotiations relating to dial-around calls.

The first option, calling party-pays, has a significant advantage in that it matches the real buyer and real seller.[5] See AT&T Comments at 13-14. The primary difficulty with a carrier-pays compensation arrangement is that it does not require the calling party to directly internalize the cost associated with using a payphone. For example, in the case of a subscriber 800 call, the called party and the terminating carrier bear all the costs associated with the call, including all costs for using the payphone. The calling party does not know or care about the costs for such calls, and therefore has no incentive to seek out a more affordable alternative.[6] As the Consumer-Business Coalition (at 9) correctly points out, "while a caller placing a local coin call

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[4] See, e.g., AirTouch at 3 ("[c]aller pays has received substantial support from a diverse cross section of commenters throughout the course of this proceeding"); Allen Lund Co. at 2 ("caller pays would certainly eliminate [800 calling] fraud and abuse."); Cable & Wireless at 1; CompTel at 8; Excel at 4; Frontier at ii; ITA at 2; LCI at i; PCIA at 2; MCI at 8-9 (if the Commission is going to use a carrier-pays system, it must base the rate on economic cost); Sprint at iii; IXC Communications at 2 (advocating cost-based rates); Paging Network, Inc. at 10-11 (advocating cost-based rates); Vocall at 6 (advocating cost-based rates); Consumer-Business Coalition at 1 (advocating cost-based rates); SkyTel at 6-7 (advocating calling party-pays); WorldCom at 5-6 (advocating calling party-pays).

[5] Sprint (at 8-9) soundly demonstrates that 47 U.S.C. § 226(e)(2) does not bar a calling party pays compensation scheme. Further, Sprint (at 10) convincingly shows that 47 U.S.C. § 228(c)(7) does not apply to PSPs and therefore that Congressional intent would not be undermined by a calling party pays arrangement for subscriber 800 calls placed from a payphone.

[6] See also Cable and Wireless at 8 ("the caller in an access code or subscriber 800 context is virtually indifferent to the cost of the call being placed."); Citicorp Services at 4 (shifting the cost from the caller to the 800/888 number owner distorts incentives to shop for the best price); CompTel at 15 ("[t]he caller does not pay the PSP directly, may not be aware of the charge, and is not affected by the same factors that are present in local calling.").

is well informed of the rate he or she will pay and, accordingly, exercises discretion in deciding whether to place the call, a caller placing an 800-number call is less likely to know, or care, about the rate that will be incurred because the caller is often not the one paying for the call." The Commission has recognized that this same type of "externality" will undermine the ability of competitive forces to constrain terminating interstate access prices. See Access Charge Reform, First Report and Order, FCC 97-158 ¶¶ 350-57 (1997). That conclusion applies with equal force to dial-around and subscriber 800 calls made from payphones. Simply put, under a carrier-pays approach, competition will not have the desired effect on the rates charged by payphone providers. It is no surprise, then, that a large portion of the commenters strongly support the calling party pays approach.[7]

Strong support for the second market-based alternative actually comes, albeit inadvertently, from the PSPs themselves. AT&T has urged the Commission, if it insists on retaining a carrier-pays system, to use a market surrogate derived from the dial-around compensation rates AT&T negotiated with the IPPs. See AT&T Comments at 14-15. The LEC Coalition (at 8-10) and the APCC (at 26-28) also advocate this same approach, but substitute 0+ commissions as the market surrogate. As AT&T explained in its September 9, 1997 Reply Comments (at 34-37), 0+ commissions reflect different business opportunities and economics than dial-around or subscriber 800 calls, and cannot be a proper starting point for determining

[7] Tellingly, the LEC Coalition and the IPPs have very little to say about the calling party-pays and market surrogate approaches suggested by AT&T and other commenters, despite the fact that numerous parties have consistently advocated them from the beginning of this proceeding. Sound economics notwithstanding, the LEC Coalition (at n.24) devotes just a single footnote to the calling-party pays approach.

fair compensation here.[8] Indeed, the Commission rejected the 0+ commission surrogate for exactly these reasons. See First Report and Order ¶ 69.

Nevertheless, the basic methodology of this approach remains sound. Dial-around compensation rates established through negotiation between AT&T and IPPs more accurately reflect the rates that would emerge in a truly competitive environment for those same dial-around calls.[9] See AT&T Comments at 15; Sprint at 13-15. At a time when AT&T's average revenue from dial-around calls was approximately $2.50, those negotiations produced a 25 cent per minute dial-around compensation fee, i.e., a 10 percent payment rate. If the Commission applies this 10 percent rate to today's average revenue of about $2.20 for each such call, then dial-around calls would have a market surrogate rate of about 22 cents. But dial-around calls constitute only one-third of all compensable calls, so the 22 cent rate must be blended with a market surrogate rate for subscriber 800 calls. Those calls generate average revenues of under 50 cents, yielding a compensation rate of no more than 5 cents (10 percent of 50 cents) per call. Given that subscriber 800 calls represent two-thirds of compensable calls, the blended rate for all

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[8] Again, the Commission need look no further than the LEC Coalition and the APCC's comments to see that using 0+ commissions as a surrogate for dial-around and subscriber 800 calls does not produce just and reasonable rates. Both sets of PSP commenters maintain that the Second Report and Order's avoided cost approach produces "just and reasonable" rates. See LEC Coalition at iii; APCC at 7. While AT&T disagrees with this characterization, it certainly cannot be true that the use of 0+ commissions also produces a just and reasonable rate when it generates a rate that is substantially higher than the avoided cost approach.

[9] Indeed, if anything, these rates are likely to exceed cost-based rates. The IPPs have market power vís-a-vís carriers in connection with dial-around and 800 subscriber calls. Consequently, if the IPPs were willing to agree to these rates during the earlier negotiations, which involved no compensation at all for 800 subscriber calls, then the rates almost certainly reflect a mark-up over cost.

compensable calls should be about 11 cents.[10] Thus, the 11 cent rate provides a fair estimate of what a willing carrier buyer would pay for a coinless call in a truly competitive market. See AT&T Comments at 14-15.

II. IT COULD NOT BE CLEARER THAT THE DEREGULATED LOCAL COIN RATE CANNOT BE USED AS THE STARTING POINT FOR A MARKET-BASED RATE, BECAUSE LOCAL COIN RATES EXCEED EFFICIENT LOCAL COIN CALLING COSTS.

The validity of the Second Report and Order's avoided cost approach depends on whether the deregulated local coin rate has converged toward cost. The fact that the Commission deregulated the local coin market is not sufficient justification for the Commission to declare ipsi dixit that local coin rates are approximate costs. The D.C. Circuit made exactly this point in remanding the Second Report and Order:

> [w]hile we held that "it was not unreasonable for the Commission to conclude that market forces generally will keep prices at a reasonable level, thereby making location monopolies the exception rather than the rule," this holding went to the Commission's decision to deregulate the coin call market, not to the question of whether coin call rates converge with costs.

MCI Telecommunications Corp. v. FCC, 1998 WL 242245 at *3 (D.C. Cir. 1998) (citation omitted).

Similarly, the Commission itself has implicitly recognized that market forces have yet to drive local coin rates to cost-based levels. See Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, First Report and Order, 11 FCC Rcd 20541, ¶ 11 (1996) ("First Report and Order") ("the payphone industry has the potential to become very competitive.") (emphasis added). That is why the

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[10] The 11 cent rate is derived by calculating a weighted average of the dial-around and subscriber 800 market surrogate rates: 1/3 x 22 cents + 2/3 x 5 cents = 10.67 cents.

Commission explicitly left the door open to future regulation of the local coin rate. First Report and Order ¶¶ 15, 59-61. Thus, on remand, the Commission may adopt its so-called market-based approach only if there is specific, credible evidence that the rates for local coin calls are at or near the costs of an efficient provider of such calls.

There is simply no record support for this conclusion. Indeed, although the Commission has sought information and comment on whether or not the local coin rate converges to cost (Notice at 2), the LEC coalition again failed to provide cost data that would permit the Commission to resolve this issue. Instead, the LEC Coalition fervently maintains that the avoided cost approach adopted in the Second Report and Order[11] is reasonable because the local coin calling market is competitive. The LECs' arguments fall into two categories, both of which fail to prove their assertion. First, they claim that because market forces set the deregulated local coin rate, the local coin rate is a reasonable starting point from which to initiate an avoided cost calculation. See, e.g., LEC Coalition at v ("so long as the local coin rate is effectively competitive" the coinless rate "will reasonably reflect the cost of service"). But as their own experts admit, the validity of their arguments are balanced precariously on the assumption that the local coin rate is determined by unimpeded competitive forces, i.e., competition that drives end-user rates down to efficient levels.[12] Second, the LEC Coalition (at 20-22) argues that because the Commission deregulated the local coin market, that market must be competitive. And because the local coin market is competitive, coin rates must be at (or near) cost. Again, like the first argument, this argument hinges on the ability of competition to constrain end-user

[11] Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, Second Report and Order, 13 FCC Rcd 1778, ¶ 11 (1997) ("Second Report and Order").

[12] See, e.g., Becker Decl. ¶¶ 35-37; Kahn at 3; Hausman ¶ 18.

rates. But as shown in the comments and further demonstrated below, competition simply does not constrain local coin rates. Thus, the PSPs' arguments cannot support our avoided cost methodology.

A. Competition Among PSPs Has Increased, Not Reduced, Local Coin Call Rates.

It is well accepted that in most markets competition drives prices down toward cost. If the market rate were above cost, any firm could undercut its competitors and profitably serve the whole market. In other words, in most markets the price charged to the consumer is a firm's principal competitive tool.

But the payphone market is not like most markets. PSPs do not compete with one another by lowering the price they charge end-users. Instead, whichever PSP pays the highest commission to a location owner obtains the exclusive right to serve the location and enjoys a location monopoly. See AT&T Comments at 2-6. As Dr. Baumol explains in the attached declaration, what competition there is in the payphone industry is competition for the right to use location monopolies. See Baumol Decl. at 6. Put another way, "'[c]ompetition' in the payphone marketplace is between payphone service providers (PSPs) to be selected by the location provider as the provider of payphones on the premise." MCI at 2. Thus, the location provider and the PSP are engaged in bilateral negotiations to split monopoly rents – and the pool of monopoly rents they split will be maximized only if the PSP charges prices well in excess of its own costs.[13]

[13] See also MCI's excellent analysis of the lack of competitive constraints on local coin rates at 3-8 of MCI Exhibit 1.

The PSPs' arguments that location monopolies do not exist are belied by the fact they have not pointed to any data showing meaningful multi-party competition in same location.[14] Indeed, the PSPs' own press releases make plain that they only compete for location monopolies, not end- users. For example, U S WEST has stated that "[t]here are many other Pay Phone Service Providers competing vigorously for sites . . .." Thus, it stated that it must raise prices so it can "pay market based commission to our location providers." U S WEST, March 2, 1998 press release, "U S WEST Raising Price of a Local Phone Call to 35 Cents in Idaho." Similarly, Bell Atlantic informed the public that it raised prices for local coin calls because of its "need to pay competitive location commissions and charge competitive retail prices." Communications Daily (Vol. 18, Number 131, p. NA(1).)

The fact that PSPs must compete vigorously for locations is not surprising, because location owners do not want multiple PSPs at a single site. "[B]ecause the location owner's commission typically is a percentage of revenue, the location owner has an incentive to cooperate with the PSP in increasing end-user charges as much as possible." Cable & Wireless at 4. If the location owner were to license multiple PSPs at a single site, then those PSP might compete with one another on the basis of price effectively destroying the location monopoly. This outcome harms the location owner, however, because it is "[t]he existence of these location monopolies [that] enables PSPs to charge excessive coin call and 'dial around' prices that far exceed the true economic costs of using their phones." ITA at 4. Preservation of the PSP's location monopoly permits the PSP to charge supracompetitive rates that the location owner can

[14] See AT&T, pp. 4-5; Cable and Wireless at 4 ("the locational monopoly is the norm, not the exception"); CompTel at 10; Consumer-Business Coalition at 8; ITA at 4; LCI at 4; MCI at 2.

collect at least in part through payphone commissions. Moreover, location owners' right to control payphone placement on their premises cannot be modified by the Commission.[15]

In fact, PSPs do not behave like price competitors as we would expect them to be if they were located at the same place. As Dr. Baumol asks

> Can anyone seriously claim to have seen many examples of customers, out to make a single call, shopping around from phone to phone? Has anyone ever seen a profusion of competitive advertisements by different PSPs, each claiming to offer lower price than the other? In contrast, we constantly see such TV advertisements of the prices of the rival interexchange suppliers, each dramatically claiming to offer lower prices than the other. The notion that there is effective price competition for coin telephone service is patently absurd.

Baumol Decl. at 7.[16]

To the extent the PSPs' acknowledge that location monopolies exist, they maintain that local coin rates are equal to costs because payphone rates must recover the costs of the increased location commissions. As explained by Dr. Baumol, however, this stands the problem on its head. Baumol Decl. at 7-10. Coin call rates might equal coin call costs, but only in the sense that a higher rate will lead to higher rents for location providers. In other words, competition in the payphone market does not drive rates to cost; rather, it drives costs to rates.[17] A 25 cent local

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[15] AT&T, p. 5.

[16] See also Vocall at 6 ("[c]ompetition to pay high commissions drives up payphone rates, and operates against the development of competition between PSPs to establish lower end-user rates.").

[17] Similar behavior has been observed in other markets. For example, the taxi-cab market in New York exhibits competition to obtain the limited "medallions" required to operate a taxi rather than competition that lower prices for consumers. See Baumol Decl. at [cite]. In the New York taxi-cab market, service providers compete to obtain medallions. In the payphone market, service providers compete to obtain locations.

coin rate would still fully compensate efficient PSPs because location commissions would decrease, reducing the monopoly rents earned by location owners.[18]

Not surprisingly, then, the evidence clearly shows that competition simply does not constrain local coin rates. As an initial matter, there is no empirical evidence of price competition in the local coin market; rather, the record indicates that local coin rates in and across many states increased to 35 cents following deregulation. If the payphone market were "becom[ing] very competitive" (First Report & Order ¶ 11), then one would expect rates to differ in different areas within a state and around the country depending upon the level of competition. By contrast, "[t]he uniformity of the coin rate increase illustrates that the nature of competition in the payphone industry does not include competition for the rates paid by end-users from payphones." Cable & Wireless at 4. See also CompTel at 9. This is especially true if, as the record shows, LECs have lower costs than IPPs. By any measure, one would not expect that a competitive market would result in payphone providers increasing their rates almost simultaneously by 40 percent, especially if efficient PSP costs are in the ranges shown in AT&T's prior pleadings. See, e.g., AT&T Reply, dated January 20, 1998, pp. 14-16. Simply put, deregulation of the local coin rate has lead to a huge increase in costs to consumers with no increase in the amount of local coin competition. LCI at 3; see also Cable & Wireless at 3 ("the only change brought on by deregulation has been an increase in local coin rates.").

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[18] If an efficient PSP incurs costs of 10 cents per call, excluding location commissions, and can charge 35 cents per local coin call, the location owner may be able to obtain a commission as high as 25 cents on each local coin call. If the PSP can only charge customer 25 cents per coin call, the location owner would be able to extract as much as 15 cents per coin call. In both scenarios the payphone is deployed and the PSP is fully compensated. The advantage of the 25 cent local coin rate, however, is that consumers enjoy lower prices and the location owner does not earn an additional 10 cents in monopoly rents. This phenomenon further supports AT&T's (continued . . .)

In addition, the evidence relied upon by the PSPs to support the existence of a competitive payphone market, namely ease of entry and the number of payphone providers (First Report and Order ¶ 11), is suspect in light of a consolidation trend in the industry. Incumbent LECs have merged at an alarming rate and, through its acquisitions, Davel Communications Group now rivals in size some Regional Bell Operating Companies payphone affiliates. See Consumer-Business Coalition at 8; AT&T Comments at 5-6. If SBC acquires Ameritech, 1.4 million of the 2.0 million payphones will be controlled by only six decision-makers. More important, though, the ease of entry and the number of payphone providers makes no difference in the absence of "location-by-location competition[.]" Consumer-Business Coalition at 8. There could be thousands of PSPs, but unless PSPs compete head-to-head with one another at the same location on the basis on price, PSPs will continue to enjoy location monopolies and be able to charge excessive rates. See Baumol Decl. at 5 (demonstrating that a large number of firms does not ensure competitive pricing.)

Finally, although local coin rates have increased after deregulation, as AT&T and other industry participants predicted, the much heralded prediction of the PSPs – that payphone deployment would increase – has yet to occur. Both Cable & Wireless (at 4) and CompTel (at 9) noted that there appears to be no substantial change in payphone deployment despite the general rate increase.

(. . . continued)
prior showing that location commissions should not be included in the coinless rate. See AT&T Reply Comments, dated July 15, 1996 at 9-10.

B. Local Coin Call Rates Exceed The Costs Incurred By An Efficient PSP.

Based on the preceding economic analysis alone, two observations can be made about the payphone industry. First, local coin rates exceed significantly the costs of an efficient PSP. Second, higher cost providers can continue offering payphone service without being forced to reduce their costs in response to competitive pressures.[19]

The record evidence unequivocally bears out these observations. As an initial matter, the payphone market apparently sustains inefficient service providers. The IPPs insist that their costs are higher than the cost of the incumbent LECs. If this is true, then competition should either drive them from the market, or they should be forced to reduce their costs to the levels enjoyed by the incumbent LECs. Nevertheless, the Second Report and Order adopted a coinless call compensation rate that actually encourages inefficient providers to remain in the market. See Baumol Decl. at 11-12.

More importantly, if the Commission intends for consumers to enjoy the best quality service at the most affordable prices, it must not set rates so as to compensate inefficient providers. Instead it must look to the costs incurred by efficient PSPs.[20] For example, AT&T conducted a bottom-up study that supports a coinless rate of 12.2 cents. AT&T Reply, dated September 9, 1997 at 14. When viewed against LEC data that has been obtained – contrary to the efforts of the LECs themselves – it is clear that the rate adopted in the Second Report and Order exceeds the efficient costs of a local coin call, not to mention the lower cost of a dial-

[19] Dr. Baumol demonstrates that the deregulated rate for local coin calls is likely to equal the costs of the highest cost, least efficient PSP in the market, not those of the most efficient PSPs, as would be socially desirable. Baumol Decl. at 10-12.

[20] Sprint has repeatedly demonstrated that the Commission "has a long history of basing rates in regulated multi-provider markets on the costs of the most efficient . . . provider," (see Sprint at 15-16), a position the Commission has inexplicably and totally abandoned in this proceeding.

around or subscriber 800 call. See SkyTel at 2. Data collected on SBC indicate that its total costs for local coin calls are well under 25 cents per call and that a reasonable cost-based compensation rate for coinless calls from SBC phones is only about 16 cents per call.[21] According to Cable & Wireless (at 10), the LEC data indicate that local coin costs lie between $0.10 and $0.15 per call. Sprint (at iii) shows that the evidence in the record supports a cost-based compensation rate no higher than 14.3 cents. And, most tellingly, the New York Department of Public Service has informed the Commission that Bell Atlantic's own cost studies support a cost well below $0.25 per call:

> In 1997, New York Telephone Company (d/b/a Bell Atlantic – New York) submitted a long run incremental cost analysis indicating that local coin revenues, based on a $.25 local coin rate, exceed relevant coin call costs. It is unlikely that other carrier payphone providers have substantially different costs.

NYPSD at 1-2. This objective submission by New York Public Service Department should erase any doubt that a 35 cent local coin rate exceeds cost, especially considering that the cost study on which the NYPSD relied was conducted by a major PSP.[22] Without question, then, any coinless rate based on the local coin call rate will be excessive "no matter how justifiable the intervening calculations may be." Baumol Decl. at 1.

The LEC Coalition attempts to counter this overwhelming evidence by suggesting that "lower volume payphones simply did not cover the costs of the payphone at the regulated

[21] AT&T Reply, dated January 20, 1998, at 15-16.

[22] The IPPs attempt to shore up the excessive 35 cent rate by pointing to uncollectible expenses that they insist will go up because PSPs will have to collect from hundreds of resellers. APCC at 19. But under the Commission's rules, IPPs will have no need to invoice resellers, except for the initial interim period, because per-call compensation must be tracked and paid by facilities-based carriers. Moreover, given the highly unusual experience to date with payphone compensation, there are no reliable data upon which to base an added collection cost to PSPs.

rates."[23] Nothing could be further from the truth. For example, data regarding SBC show that at 478 calls per month (the average supplied by the LEC Coalition), SBC's total costs were for local coin calls less than 25 cents per call, including a return on capital. Moreover, the LEC Coalition willfully ignores the role of semi-public phones for which PSPs receive support from location owners and the public interest payphone section of The Act (47 U.S.C. § 276(b)(2)) that specifically addresses the provision of payphones in low volume areas.[24] Instead of inflating the costs of calls on all payphones so that PSPs will deploy payphones in low revenue areas, the Commission should ensure that payphone rates are set at efficient levels for the large preponderance of calls. The other mechanisms can then be used where necessary without forcing carriers and consumers to pay significantly inflated rates on every payphone call.[25]

The LEC Coalition (at 13) tries to salvage the Second Report and Order's avoided cost approach by arguing that it is "fair" because it forces all payphone calls to contribute the same "proportion" to the joint and common costs of the payphone. As an initial matter, this is incorrect because all users would contribute the same amount to joint and common costs, but coinless calls will contribute a larger proportion, because the compensation rate for coinless calls is lower than the local coin rate.

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[23] The LEC Coalition (at v) implies that rounding to the nearest nickel may be, on average, downward rather than upward and, presumably, result in rates that are too low. This scenario will not arise because if rounding down produced undercompensatory rates, PSPs would exit the market until rates rose to compensatory levels. Rounding can produce rates above cost, however, if potential entrants know that post entry prices will result in rounding down and therefore undercompensatory rates.

[24] The Second Report and Order also failed to address these issues.

[25] According to the PSPs' reasoning, if a 35 cent local coin rate was necessary to encourage the deployment of a phone at one low revenue location, they should be permitted to charge carriers a compensation rate based on 35 cents a call at a thousand other locations even though only a much lower rate is needed to cover the PSP's costs.

Moreover, payphone joint and common costs are very small.[26] The LEC Coalition claims that the instrument and maintenance are common costs, but that is not true. A coin call uses the entire instrument including the coin mechanism, but a coinless call does not need or use those capabilities. Coin calls require maintenance of the coin mechanism, coin collection, and increased repairs because of vandalism aimed at stealing the coins. Coinless calls require none of these expenses. In other words, most payphone costs can be directly attributed to either coin or coinless services making the total amount of joint and common costs relatively small.[27]

In short, the PSPs have failed to show that the local coin rate converges to the cost of local coin calls. Instead, they blindly claim that price competition exists among payphone providers – which it does not – and assume away the Court's direction to show that local coin costs and rates converge. Thus, Frontier (at 5) is clearly correct that "[t]he record conclusively demonstrates that the local coin rate far exceeds the cost of even a local coin call."

C. The Commission Should Not Let The Coinless Compensation Rate Float.

In all events, the Commission cannot permit the coinless compensation rate to "float." The foregoing analysis clearly demonstrates that PSPs have the incentive and the ability to

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[26] Professor Kahn states that AT&T's expert Dr. Warren-Boulton admitted that the preponderance of payphone costs are common. Kahn Decl. at 3. To the contrary, Dr. Warren-Boulton has steadfastly maintained that common costs are a relatively small component of total cost.

[27] The LEC Coalition (at 17) also insists that the avoided cost approach is fair because it allows PSPs to recover the opportunity cost associated with coinless calls placed on their equipment that displaces local coin calls. This argument is not only wrong, it proves that the 28.4 cent coinless rate is excessive. Even assuming a payphone call last 6 minutes, the average payphone is in use less than 10 percent of the time. At 700 calls per month (the IPP average) 6 minute average calls would generate only 4200 minutes of use out of the more than 43,000 minutes in each month. Thus, coinless calls do not generate an opportunity cost because payphones have plenty of excess capacity. And if the 28.4 cent rate allows PSPs to recover an opportunity cost they do not incur, it goes without saying that the PSPs recover too much.

charge rates far in excess of cost. These problems would be greatly exacerbated if the rate were allowed to "float." Even if there were perfect competition in local coin market – which there is not – PSPs will have incentive to increase local coin rates in order to make more money from non-coin calls. See AT&T Comments at 11-12. Hence, an increase in the local coin rate might reduce the demand for coin calls, but any lost revenue could be offset from increased coinless call revenues. Simply put, a floating rate will harm consumers by creating even greater incentives for PSPs to raise local coin rates. Moreover, it would create an administrative nightmare for carriers, who would have to constantly monitor varying rates from over 2 million payphones. This, in turn, would foster disputes (and regulatory complaints) over payment and cause additional transaction costs that will ultimately have to be passed on to consumers.

III. THE PSPs HAVE NO CREDIBLE RESPONSE AS TO WHY COST-BASED RATES ARE NOT WORKABLE

In an attempt to shore up the problems with the Second Report and Order's avoided cost approach, the PSPs level a number of disingenuous and false attacks against AT&T's alternative cost-based rate proposal. These specious arguments include claims that cost-based rates: (i) require a rate-of-return proceeding, (ii) are inaccurate, (iii) provide an incentive for PSPs to inflate their costs, (iv) require a phone-by-phone study, and (v) are too contentious for the Commission to use. These arguments are no more than scare tactics aimed at convincing the Commission to reject the best method for setting a cost-based compensation rate in the real-world circumstances of the payphone market, i.e., a bottom-up cost analysis. In fact, a properly conducted top-down (avoided cost) analysis, unlike the one conducted in the Second Report and Order, may be more complicated than a bottom-up study.

As an initial matter, the LEC Coalition (at 4) and the APCC (at 9) attempt to portray a bottom-up cost approach as rate-of-return regulation because AT&T and other commenters favoring cost-based rates (under a carrier-pays system) asked the Commission to collect cost data from the largest PSPs. But, collecting and analyzing this data does not amount to rate-of-return regulation. AT&T and other commenters recognized that in order for the Commission to fulfill its duty not to engage in arbitrary and capricious rulemaking, it must take into account LEC cost data, not just the higher cost IPP data.[28] There is no dispute that LEC PSPs own the vast majority of payphones. Accordingly, "[a]ny cost analysis must reflect the fact that LECs operate approximately 75 percent of the payphones in the nation."[29] Cable & Wireless at 10.

Further, the Commission has routinely required bottom-up cost studies and, consequently, it has no reason to believe that a legitimate bottom-up cost analysis will produce inaccurate results. Of course, any cost study will have some degree of approximation, but a thorough, transparent cost study is vastly superior to the obvious inflation in the coinless compensation rate generated by the Second Report and Order's avoided cost methodology. Moreover, if the LEC Coalition (at 4-5) is so concerned about error, its members should have submitted reasonably verifiable data that would have increased the accuracy of the bottom-up analysis.[30]

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[28] See, e.g., AT&T Comments at 15-16; Sprint at iii.

[29] See also Paging Network, Inc. at 11; Personal Communications Industry Association at 6; Sprint at 17; LCI at 9; Excel at 11.

[30] The IPPs' experts argue that there is a circularity problem in setting cost-based rates because the cost-based rate is dependent on the number of payphone and the average use of each payphone. The number of payphones and the amount of usage, in turn, depend on the rate. See Harring and Rohlfs Decl. at 20-28; APCC at 11. This problem, however, arises in any rate-setting process. Therefore, any rate the Commission establishes for coinless calls will in turn
(continued . . .)

The LEC Coalition (at 5) also claims that cost-based coinless rates will create incentives for PSPs to inflate their costs. This argument is nonsense. A bottom-up cost approach should focus on the costs of an efficient provider. Thus, higher costs of a less efficient provider become irrelevant. And if a PSP actually inflates its costs, it will only reduce its profitability because the efficient costs will remain the same. By contrast, the Second Report and Order rewards cost inflation because it sets rates based on the costs of high cost, i.e., less efficient, providers. The Commission should also note that this problem would be greatly exacerbated if it allowed the coinless compensation rate to float.

The PSPs two remaining arguments hardly warrant a response. First, contrary to their claims, a bottom-up approach will not necessitate a phone-by-phone study. By and large, the costs of coinless phones, and therefore the costs an efficient provider would incur in providing service using coinless phones, do not vary from phone to phone. So long as the coinless rate covers an efficient provider's average coinless payphone costs, there is no reason to be concerned with phone-by-phone costs.[31] Second, while the process of approving a rate based on a bottom-up analysis may be contentious (see LEC Coalition at 4), that would be no different than any other cost proceeding. Indeed, this argument itself is ironic given that the "simple" avoided cost approach has already occupied the Commission for two summers.

Tellingly, these same criticisms would apply to the avoided cost approach, because that approach also requires Commission to determine cost differences between coin and coinless

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affect the demand for and supply of payphones and payphone usage. In other words, Harring and Rohlfs' criticism applies equally to the avoided cost approach.

[31] As previously discussed, to the extent that the Commission is concerned about payphone deployment in low revenue areas, it should address that issue through the public interest telephone section of The Act. See 47 U.S.C. § 276(b)(2).